Japan - February 2022

SPOTLIGHT
Savills Research

Japan Hospitality

savills

Opportunities amidst the uncertainty

Summary

- Japan's borders remain closed to tourists, and the Omicron variant has further disrupted the recovery of inbound tourism.
- Hotel bankruptcies are comparatively high, signalling that many players are financially distressed.
- The luxury hotel sector has garnered the attention of many brands that are looking to expand their footprint into the market.
- Hotels saw some recovery in occupancy in the second half of 2021 even without the aid of the "Go To" Travel program.
- Investment volumes in the hotel sector were on par with the previous year and are expected to increase in 2022.
- Opportunities in the Japanese hotel market are likely to further emerge in the near future.

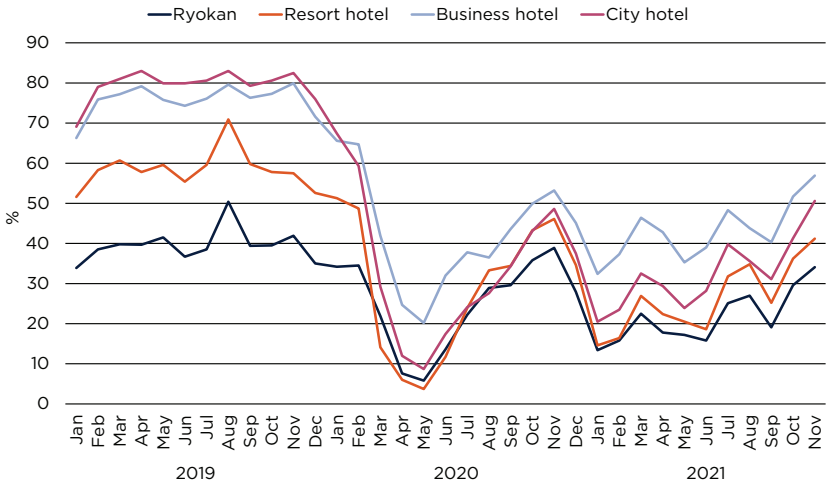
INTRODUCTION

Almost two full years have passed since the onset of the pandemic in early 2020, with Japan's borders remaining closed in principle throughout 2021. While the Japanese government initially planned to experiment letting some tourists back in December 2021, the emergence of the Omicron variant threw a spanner in the works, and strict border measures were extended likely until the end of February.

Nonetheless, there are some positives for the hospitality industry as a whole. Firstly, at the start of 2022, the percentage of fully vaccinated residents in Japan was around 80%. The distribution of the booster shot has already started and is being accelerated. Furthermore, restrictions pertaining to domestic travel have generally been relaxed. This is a big relief especially to the hospitality industry in Japan, where domestic travellers comprised more than 80% of total demand before the pandemic.

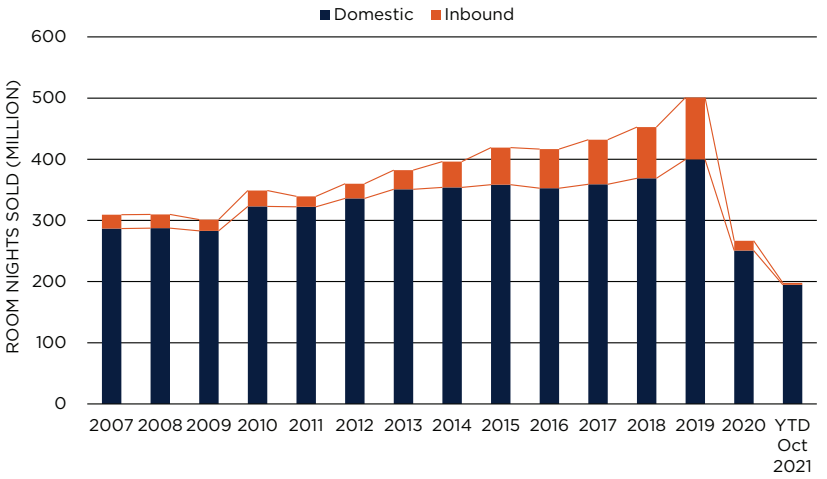
In fact, looking at Graph 1, some recovery has been observed in occupancy rates. The increase in COVID-19 cases and suspension of the "Go To" Travel campaign at the end of 2020 caused a plunge in occupancy rates at the start of 2021. However, since then, occupancy rates have slowly trended upward even during periods when there were spikes in COVID-19

GRAPH 1: Occupancy rates by hotel type in Japan, 2019 to November 2021



Source Japan Tourism Agency (JTA), Savills Research & Consultancy

GRAPH 2: Total room nights sold to domestic and inbound guests, 2007 to October 2021



Source JTA, Savills Research & Consultancy

cases, and without the boost from the "Go To" Travel campaign. As of November 2021, occupancy rates were around the same as the highest levels observed in 2020, showing that the hospitality industry in 2021 was on course to be in better shape than 2020, albeit gradually.

There are admittedly uncertainties and hurdles ahead for hotel operations. For instance, the Omicron variant and potential new variants pose an imminent threat. Even if demand recovers, there may be challenges in acquiring new talent, as many workers were forced to leave the industry during the pandemic. Finding and training new employees will incur additional costs, straining the already thin operating margins that the hospitality industry runs on. This may surprise unprepared investors when they look at actual cash flows a few years later.

However, in the longer-term, the hospitality industry is expected to get back on the growth track that it was on prior to the pandemic. Provided that there is plenty of pent-up demand domestically and globally, opportunities are also abound in the industry. The following two sections will explore the circumstances surrounding bankruptcies, as well as the luxury hotel sector.

While domestic tourism has seen some recovery, times are tough for the hotel industry, with increasing bankruptcies and delayed recovery due to new variants. However, opportunistic investors still see this as a chance to enter or expand into the Japanese hotel market.

LODGING BANKRUPTCIES IN JAPAN

With the pandemic drastically decreasing revenue from not only accommodation, but from other key revenue streams such as corporate events and banqueting[1], the hospitality industry has undoubtedly been struggling over the past two years. 2020 saw a rapid increase in the number of bankruptcies, exceeding 120 cases, more than half of which were a result of the pandemic. While the number of bankruptcies in 2021 has fallen, more than two thirds were due to the pandemic, showing its lingering effects.

Furthermore, the number of bankruptcies in the hospitality industry over the past two years appears more subdued than it actually should be. According to Tokyo Shoko Research, 2021 had the lowest number of bankruptcies in 57 years. In contrast, the number of bankruptcies in the hotel industry has stayed on par with an average year. One reason for this was the financial support provided by the Japanese government in the form of no-interest loans backed by public credit guarantees. Moreover, banks initially granted moratoriums, giving the industry even more breathing room and time to adapt to the challenging environment. That said, this moratorium period is likely to end sooner than later, which may lead to further bankruptcies or more transactions. Indeed, Japanese banks remain selective and cautious towards hotel acquisitions, although they have steadily become more accommodative to deals.

While there has been some recovery in travel over the past few months, many hotels are nonetheless still deep in the red. In fact, in December 2021, Seibu Holdings announced that they would be separating the ownership and operations of the hotels, ski resorts, and golf courses that were previously both conducted by its subsidiary Prince Hotel, and focus on operations via a newly established subsidiary. It has recently entered talks with GIC to sell about 30 of its properties for approximately JPY150 billion.

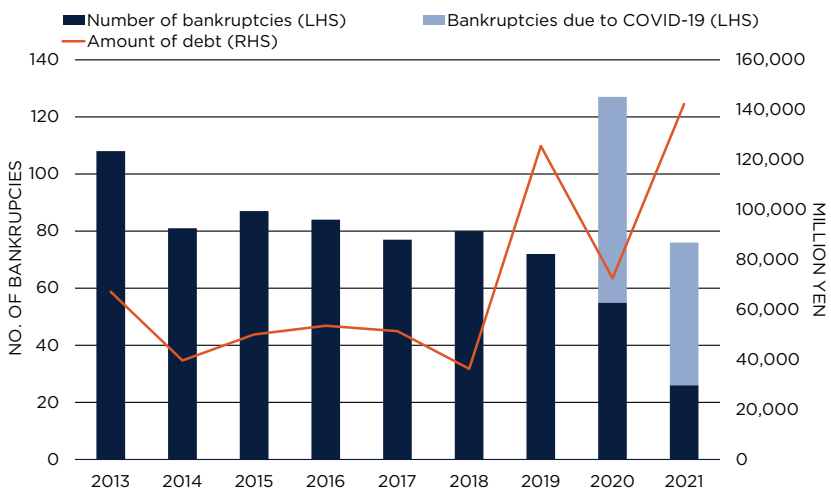
Most hotel owners traditionally prefer fixed-rent leases, and some accept a fixed-rent plus revenue sharing payment structure. However, the pandemic has led to an increased number of hotels without operators, especially those newly built by real estate companies. This has consequently contributed to the growing acceptance of management contracts by hotel owners. This trend may further accelerate if a large developer starts accepting this practice, and consequently create a wider operator and investor base.

LUXURY HOTELS IN JAPAN

Compared with other countries, Japan has a relatively limited number of luxury hotels. According to Five Star Alliance, Japan has slightly over 50 hotels listed. In contrast, many Western countries completely dwarf this number, and even neighbours in the Asia Pacific like Hong Kong and Singapore have a comparable number of luxury hotels despite the vast difference in the sizes of their economies. This trend is no different when analysing at a city level – cities like New York and London have more than three times the number of luxury hotels than Tokyo does. Hence, investor interest in higher grade hotels with larger guestrooms remains underserved. The supply in this category has been limited, and the demand appears stable with upside potential.

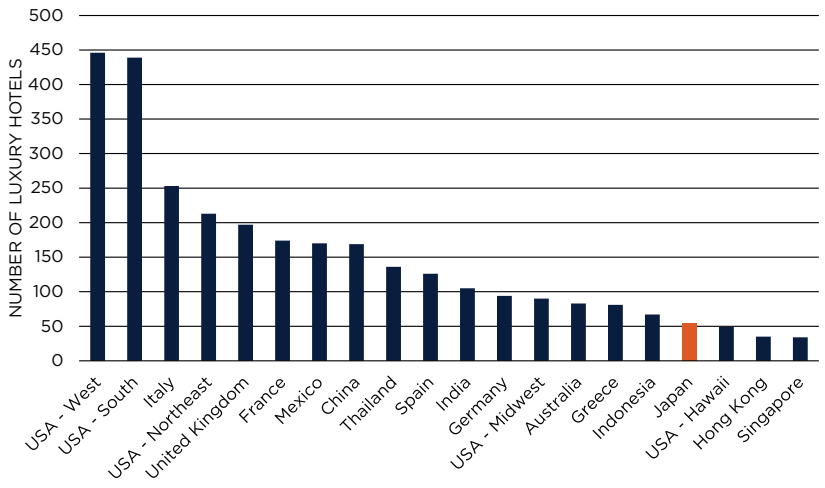
1 MICE facilities were broadly promoted before the pandemic. However, those plans appear to either have faded away or put on hold from future.

GRAPH 3: Hotel Bankruptcies in Japan, 2013 to 2021



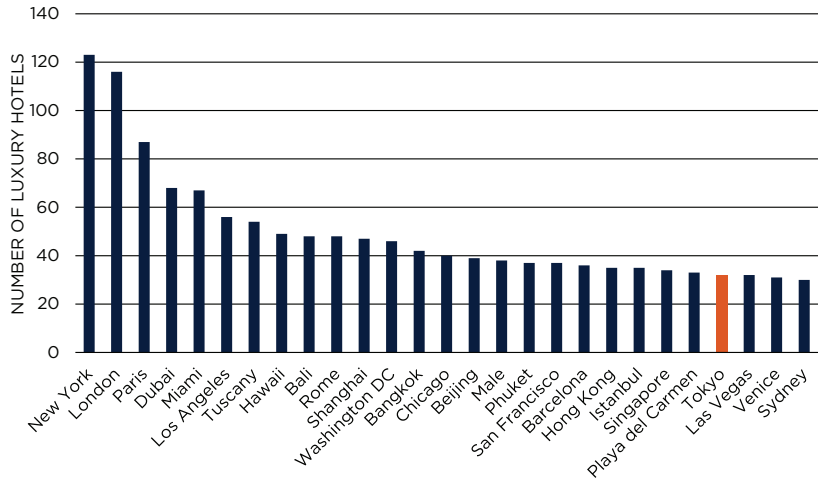
Source Teikoku Databank, Savills Research & Consultancy

GRAPH 4: Number of luxury hotels by country/region, 2021



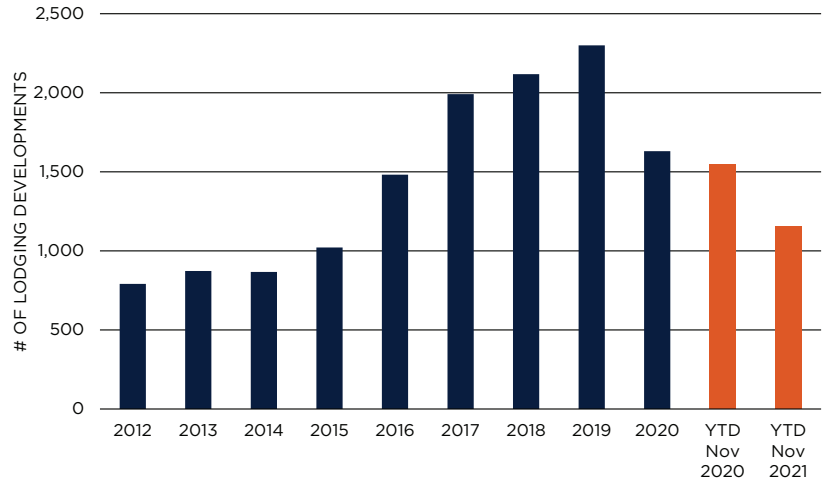
Source Five Star Alliance, Savills Research & Consultancy

GRAPH 5: Number of luxury hotels by city, 2021



Source Five Star Alliance, Savills Research & Consultancy

GRAPH 6: Lodging developments, 2012 to November 2021



Source Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

There are plausible reasons as to why Japan has a significantly smaller number of luxury hotels. For instance, Japan is home to a large number of high-end ryokans, traditional inns, which are luxurious in their own right, but are not technically classified as luxury hotels. They tend to be located far from city centres, and especially in the case of ryokans, sometimes lack some luxury amenities.

The Japanese hospitality market has traditionally been dominated by strong, large local players. Nevertheless, the relative lack of luxury hotels in Japan has caught the attention of international players, and some have seen the pandemic as a chance to enter or expand in the Japanese market. While many luxury hotels have not recovered to pre-pandemic occupancy levels, some players anticipate high levels of pent-up demand for travel, and expect tourism revenue in Japan to continue growing.

Many well-known international brands have already started opening luxury hotels in Japan. For instance, in late 2020, The Tokyo EDITION, Toranomon, was opened, and the Marriott will keep expanding its footprint with The Tokyo EDITION, Ginza in 2022. These hotels are also part of Mori Trust's Luxury Destination Network vision. Indeed, the Marriott has been active in Japan, and also plans to see the first Marriott Hotel opened in Nagasaki with Kyushu Railway in 2023. In addition, Japan's first Bvlgari Hotel is scheduled to open in 2023, occupying the top seven floors of Tokyo Midtown Yaesu. Furthermore, Hilton has also capitalised on this momentum with the opening of Roku Kyoto, LXR Hotels & Resorts in late 2021, and has announced the first Waldorf Astoria hotel in Osaka.

Some domestic players in the resort hotel industry have also been expanding their footprints. For instance, Hoshino Resorts has been rapidly developing its Kai brand by acquiring two resorts in 2021, and has plans to open two more in 2022. Elsewhere, Hiramatsu Hotels opened a new branch in Nagano in 2021, following a new opening in Kyoto in 2020. Indeed, these franchises seem confident in their branding, and appear to have stronger balance sheets than many other hotels despite the pandemic.

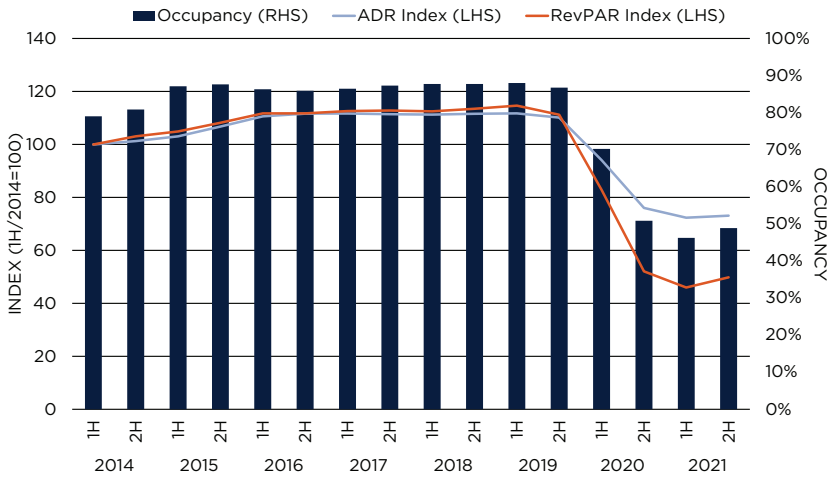
HOTEL MARKET PERFORMANCE

Savills tracks the performance of over 100 hotels owned by five J-REITs[2] to analyse market trends. Our analysis focuses on limited-service hotels; full-service and resort properties are excluded due to limited data. Given that most of the existing hotel stock is in the limited-service category, this should provide a good proxy for the overall market trend in Japan[3].

2 The five J-REITs consist of Japan Hotel REIT, Invincible Investment, Hoshino Resorts REIT, Ichigo Hotel REIT, and Mori Trust Hotel REIT. Since new samples are added when J-REITs acquire hotels, the sample size and composition may change marginally between survey periods.

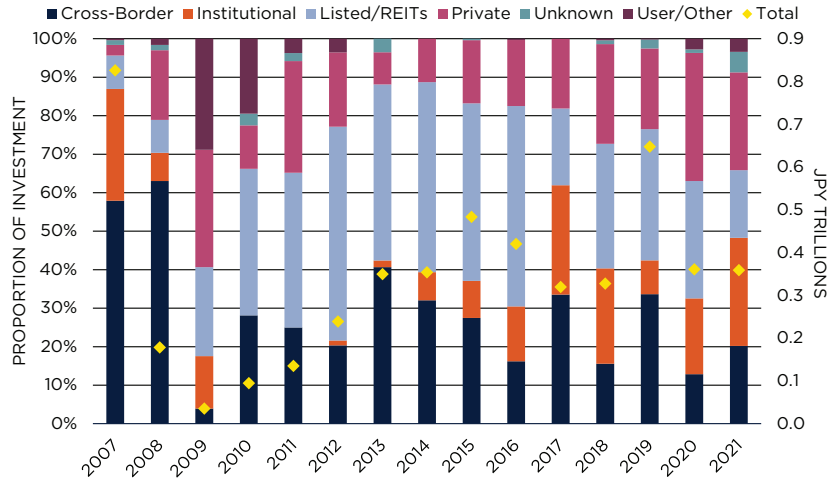
3 In this report, Tokyo accounts for over 30% of the sample hotels while other Kanto prefectures and Kansai account for about 15% each.

GRAPH 7 : Limited-service hotel performance, 2014 to 2H/2021



Source J-REIT disclosures, Savills Research & Consultancy
Note: Occupancy is calculated based on the total number of rooms each month.

GRAPH 8: Hospitality sector investment volumes by investor type, 2007 to 2021



Source RCA, Savills Research & Consultancy

TABLE 1: Selected investment transactions announced in 2H/2021

PROPERTY NAME	APPROX. PRICE (JPY BIL)	PRICE PER ROOM (JPY MIL)	CAP RATE	LOCATION	BUYER
Ibis Tokyo Shinjuku	11.3	55	4.1%	Tokyo	Undisclosed
Kai Kirishima & Kai Beppu	11.2	94	5.3% and 5.0%	Kagoshima and Oita	Hoshino REIT
The B Osaka Midosuji	10.7	35	Undisclosed	Osaka, Osaka	BPEA

Source J-REIT disclosures, RCA, Savills Research & Consultancy

Hotel performance remained weak for the most of 2021. However, one sliver of hope can be found in the slightly recovering occupancy rates from the previous half-year, which are almost at the levels seen in 2H/2020 even without the help of the "Go To" Travel campaign. Moreover, hotel revenues have also improved slightly. In 2H/2021, the average daily rates (ADR) index increased by 0.8 points half-year-on-half-year (HoH), and the revenue per available room (RevPAR) index increased accordingly, by 3.8 points HoH.

Budget hotels in particular have been hit harder by the pandemic due to the large supply in the market. The small room sizes of such hotels appear to be an issue for both customers and operators, especially after the pandemic. Looking at Graph 6, the number of lodging developments increased rapidly from 2016 to 2019, showing the pace at which competition increased. Most of the supply have been budget hotels. Moreover, it should be noted that even before the pandemic started, many of these hotels were not doing well. These hotels are likely to need to keep resorting to price wars to attract more customers and weather the storm. Furthermore, more troubled budget hotels are expected to appear on the disposition market. Therefore, the competition on room prices to attract budget travellers is unlikely to cool down anytime soon.

INVESTMENT

The hotel industry has been one of the most badly hit by the pandemic. That said, investor appetite remains robust, and the gap between sellers and buyers appears to have narrowed. Overall, looking at Graph 8, transaction volumes in 2021 were around the same as what was seen between 2017 and 2020, barring 2019 which saw an exceptionally large volume of transactions. The largest proportion in 2021 came from institutional investors, who have been notably active in the market.

Some domestic players have been active in the market. For instance, hotel chain operator Apa Group purchased two hotels in Tokyo and Nagoya from Nishi-Nippon Railroad, and acquired another hotel in Osaka in the second half of 2021. Apa Group is expanding its number of hotels, and appears to be using the pandemic as a chance to acquire underperforming assets at a discount. Indeed, as a large and experienced hotel owner and operator, Apa Group should have the resources and expertise to withstand tough times, and is likely expanding with a long-term vision in mind. Samty Asset Management also established a REIT specialising in hotels in November 2021 and plans to go public with it. Nippon Telegraph and Telephone West Corporation will be developing the site of its headquarters, located next to Osaka Castle, in a redevelopment project that features a hotel with approximately 220 rooms.

Overseas investors have also been looking at the Japanese hospitality industry. For instance, Baring Private Equity Asia acquired The B Osaka Midosuji, a large hotel in Chuo ward, Osaka, in a transaction estimated at over JPY10 billion. The hotel will reportedly be the first of the "Holiday Inn Express" brand of IHG Hotels & Resorts in Japan.

Overall, while 2021 has seen large transactions in the hotel sector, transaction volumes have been relatively low considering the pandemic. To be sure, although interest in the sector has gathered, many sellers have not been flexible on pricing. However, with more uncertainty about the timing of recovery surrounding the market and as the gap between buyers and sellers narrows, more transactions should be observed in 2022.

OUTLOOK

The hospitality sector still faces many challenges. Although occupancy rates have been slowly recovering and the second half of 2021 has seen some improvement from the first half, the two years of drastically reduced revenue has weakened many hotels, and even prompting some to exit the market. Moreover, the emergence and spreading of new COVID-19 variants continue to pose a threat to the industry, as hotels are unable to forecast the return of hotel demand in the near future. Even if demand were to rapidly increase, some hotels are likely to face hurdles acquiring labour, especially because many workers in the industry were laid off during the pandemic.

However, even with the uncertainty present in the market, some investors and players are seeing this as a chance to enter the market or expand their footprint. As the state of the pandemic drags on, distressed hotels without adequate financial backing may resort to disposing assets, leading to opportunities in the market. The number of hotels that went bankrupt in 2021 has not deviated from previous years despite the record low number of bankruptcies across all industries. Some famous domestic hotel brands with stronger balance sheets like Hoshino have been acquiring assets during the pandemic in anticipation of a recovery. We expect more deals this year due to the ending of moratorium periods and the prolonged subdued demand by the lingering pandemic.

Another area with potential opportunities is the luxury hotel sector. Compared with some neighbouring countries and many large cities in the world, Japan has a relatively small number of luxury hotels. Large international players like Marriott have been steadily expanding into the Japanese market. Indeed, there is a large amount of pent-up demand for travel, especially in the luxury sector. There are also many large mixed-use development plans across prime areas in Tokyo. Given the subdued office demand due to the pandemic, some planned office portions should be replaced by luxury hotel and residences. During this decade, more luxury hotels and residences in prime areas in Tokyo, such as Marunouchi, are therefore expected.

While risks are abound, performance is likely to vary widely from hotel to hotel by location, category, and business mix, implying that there are opportunities present in the market. The gap between some buyers and sellers has begun to narrow, which should bring more deals forward.

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